Commodity Markets Council
1300 L St., N.W. Suite 1020
Washington, DC 20005
Tel 202-842-0400
Fax 202-789-7223
www.commoditymkts.org

August 13, 2018

Via Electronic Submission

Christopher Kirkpatrick
Secretary
U.S. Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, DC 20581

Re: Comments on the Notice of Proposed Rulemaking, *De Minimis Exception to the Swap Dealer Definition* (RIN 3038-AE68)

Dear Mr. Kirkpatrick:

I. Introduction

The Commodity Markets Council ("CMC") submits this letter in response to the request for public comment set forth in the U.S. Commodity Futures Trading Commission's (the "Commission" or "CFTC") Notice of Proposed Rulemaking, *De Minimis Exception to the Swap Dealer Definition*.[1] CMC also refers the Commission to the comments it provided on January 15, 2016 in response to the CFTC's Swap Dealer *De Minimis* Exception Preliminary Report and the comments it filed on February 22, 2011 and September 20, 2010 in response to the proposed definition of "swap dealer" and the definitions contained in Title VII of the Dodd-Frank Act, respectively.[2] In addition, CMC generally expresses support for the comment letter filed by the Commercial Energy Working Group ("Working Group") regarding this same matter.

CMC is a trade association that brings together exchanges and their industry counterparts. Its members include commercial end-users that utilize the futures and swaps markets for agriculture, energy, metal, and soft commodities. Its industry member firms also include regular users and members of swap execution facilities ("SEFs") as well as designated contract markets ("DCMs"). Along with these market participants, CMC members also include regulated derivatives exchanges and price reporting agencies. The businesses of all CMC members depend upon the efficient and competitive functioning of the risk management products traded on

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[1] Notice of Proposed Rulemaking, *De Minimis* Exception to the Swap Dealer Definition, 83 Fed. Reg. 27,444 (June 12, 2018), https://www.cftc.gov/sites/default/files/2018-06/2018-12362a.pdf ("Proposed Rule").

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376, section 721 (2010).

DCMs, SEFs, and over-the-counter ("OTC") markets. Its comments represent the collective view of CMC's members.

II. The Commission Should Act Quickly To Remove The Automatic Termination of the Phase-In *De Minimis* Threshold And Set The Threshold at $8 Billion

CMC urges the CFTC to prioritize finalizing a rule that removes the automatic termination of the phase-in *de minimis* threshold and sets the threshold at $8 billion. Without this action, the *de minimis* threshold will drop to $3 billion on December 31, 2019. Because market participants must calculate their notional amount of swap dealing based on a 12-month look back, this means that market participants will need to start counting their dealing swaps executed on and after January 1, 2019 toward the lower threshold unless the CFTC takes final action before that date. The Commission should not add a dealing counterparty count or a dealing transaction count at this time because it would introduce an unnecessary level of complexity when it is more important to take immediate action to remove the automatic termination of the phase-in *de minimis* threshold.

As stated by the CFTC in the Proposed Rule, allowing the phase-in threshold to terminate or setting the *de minimis* threshold at less than $8 billion would not materially increase the transactions subject to swap dealer regulation although it could require more market participants to register as swap dealers unless they further reduce their dealing activity.[3] Because of the high costs associated with registration, many commercial commodity market participants are more likely to reduce their participation in or move out of swaps markets than to register as swap dealers as the result of a reduced *de minimis* threshold.[4] This would further concentrate dealer activity in the hands of a few, thereby reducing competition and increasing systemic risk. This concentration of dealing in a few large entities also means fewer swaps counterparties for physical commodity companies seeking to hedge.

This is not hypothetical harm. We have seen the harmful impact on liquidity when the *de minimis* threshold was set too low in the case of utility special entities. The CFTC acknowledged the negative effect that the lower special entity *de minimis* threshold might have on utility special entities because of the decrease in the number of counterparties willing to execute hedges with them in an already illiquid market. As a result, the CFTC provided relief to allow entities to exclude from the special entity *de minimis* threshold swaps with utility

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[3] Proposed Rule at 27,450-27,454.

[4] In addition to the known costs of registration, including costs for IT infrastructure to deal with a panoply of dealer requirements, such as onboarding, disclosures and portfolio reconciliation, risk management, valuations, settlement and reporting, as well as significant compliance and legal staffing costs, there are still unknown costs. Market participants still are not able to fully account for the cost of registration because the capital rule has yet to be finalized. Moreover, the limitations on eligible collateral under the margin rule only permit collateral in the form of highly liquid instruments (essentially cash and treasuries). This will be disproportionately more difficult for commercial commodity companies who do not have the same access as financial institutions to liquid collateral. These requirements pose a significant new cost on physical market participants who might have to register because of an arbitrary decrease in the *de minims* threshold.

special entities related to utility operations.[5] Under the amended rule, those swaps now are subject to the higher $8 billion *de minimis* threshold. The Commission issued the relief to ensure that special entities would have counterparties with which to trade because it recognized that utility operations-related swaps are an integral part of providing electricity and natural gas production and/or distribution continuously and at a manageable cost.

Today, illiquidity issues remain in certain market segments, including with respect to hedges for medium or long-term construction finance projects. Any decrease in the *de minimis* threshold likely would further exacerbate these limitations, resulting in badly needed projects, such as those in the gas/oil and electricity generation sector, becoming more expensive or even too costly to build.

Physical commodity markets are sensitive to variations in the *de minimis* threshold. In addition to establishing a higher threshold for utility operations related swaps, the CFTC Staff recognized this again in the Swap Dealer *De Minimis* Preliminary Report, noting that physical commodity markets "may have characteristics that make them more sensitive to variations in the *de minimis* exception."[6] The CFTC should therefore act quickly to finalize a rule to prevent the automatic termination of the phase-in *de minimis* threshold.

The Commission should avoid changes to the rule that impact processes for monitoring the *de minimis* threshold, *e.g.*, calendar year versus rolling 12-month calculations. Resources have already been spent and systems have been built to comply with the current approach. Additional changes at this point would add costs with no tangible benefit.

III. The CFTC Should Retain The Proposed Hedging *De Minimis* Exception, But Remove Certain Proposed Conditions

CMC commends the Commission for recognizing the commercial importance of expressly excluding swaps used for hedging both physical and financial positions from being counted toward the *de minimis* threshold.[7] While CMC supports the Commission's stated objectives, CMC members are concerned that the proposed provision (the "Hedging *De Minimis* Provision") could be read as narrowing the existing exclusion provided in the rules for physical hedges ("Physical Hedging Exclusion") because of the additional conditions proposed, namely, that for a given swap, "the person is not the price maker and does not receive or earn a bid/ask

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[5] Exclusion of Utility Operations-Related Swaps with Utility Special Entities from *De Minimis* Threshold for Swaps with Special Entities, 79 Fed. Reg. 57,767 (Sept. 26, 2014).

[6] Preliminary Report at 39. Any decrease in the *de minimis* threshold would disproportionately impact physical market participants not only because of the costs associated with registering as a swap dealer as discussed above, but also because of the historically low physical commodity prices since passage of the Dodd-Frank Act. Commodity prices have been at historic lows since Rule 1.3(ggg) became effective. As those prices begin to rise, the notional value of swaps executed by commodity market participants will increase **even if activity levels stay the same**. For example, a market participant executing 230,000 contracts for corn at the current market price of $3.51 cents per bushel would have executed just over $4 billion in notional value of swaps. However, if the price of a bushel of corn rises to $7.00 per bushel, that market participant would now be trading in excess of the $8 billion *de minimis* threshold despite the fact that it has not increased its activity level.

[7] Proposed Rule at 27,462.

spread, fee, commission, or other compensation for entering into the swap" ("Proposed Conditions").[8]

We understand from certain public statements made by Staff following issuance of the Proposed Rule that they intended to mirror the multi-factor approach discussed in the Entity Definitions Final Rule as applied to the Physical Hedging Exclusion.[9] However, in the Entity Definitions Final Rule, the Commission expressly avoided a rigid multi-factor test, opting instead to apply a facts and circumstances approach to the characterization of swaps activity. The CFTC should take the same approach here and rely on its existing facts and circumstances analysis rather than add a new multi-part requirement. As such, CMC requests that the CFTC retain the Hedging *De Minimis* Provision, but remove the proposed conditions set forth in proposed paragraph (4)(i)(D)(2) of the Swap Dealer definition.

IV. The Commission Should Clarify That Cleared Swaps and NDFs Do Not Count As Dealing Swaps For Purposes Of The *De Minimis* Threshold

Cleared swaps (whether exchange-traded or traded OTC) should not count as dealing swaps for purposes of the *de minimis* threshold because they pose less systemic risk than uncleared swaps. Moreover, excluding cleared swaps from the swap dealer definition further incentivizes clearing and thus many of the goals of the Dodd-Frank Act. The Staff appropriately points out in the Preliminary Report that central clearing, a core tenet of the Dodd-Frank Act, moves risk from counterparties to a clearinghouse and, therefore, minimizes the value of swap dealer regulation as applied to cleared swaps:

> [O]ne of the fundamental goals of Title VII of the Dodd-Frank Act, to reduce systemic risk, may be achieved by requiring central clearing of more swaps. Once a swap is cleared, the swap between the counterparties is extinguished and the risk mitigation is performed by the clearing organization. Accordingly, swap dealer regulation may be of limited value with regard to swaps that are executed on a SEF or DCM and/or cleared.[10]

Additionally, many of the swap dealer regulations applicable to dealing transactions either are inapplicable or redundant when considered in the context of swaps that are cleared. For example, most swap data repository ("SDR") and real-time reporting of cleared swaps is undertaken by the exchanges and clearinghouses, and the margin rule (one of the hallmarks

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[8] Proposed Rule at 27,479.

[9] D.C. Bar Meeting on CFTC Proposed Amendments to the Swap Dealer De Minimis Exception, June 26, 2018; Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 Fed. Reg. 30,596 at 30,611-30,614 (May 23, 2012) (hereinafter "Entity Definitions Final Rule").

[10] Preliminary Report at 62.

of dealer regulation) does not apply to cleared swaps.[11]

Non-deliverable forwards ("NDFs") also should not count as dealing swaps for purposes of the *de minimis* threshold. The only difference between NDFs and excluded FX Spot transactions is the duration of time to effectuate delivery. As such, both NDFs and FX Spot transactions should be excluded from the *de minimis* threshold.

V. Determinations Regarding Notional Amount Calculation Methodologies Should Be Subject To Public Comment

Many market participants have expressed to the Commission the lack of clarity around how to calculate the notional amount for various commodity swaps. CMC requests that the Commission issue proposed interpretative guidance clarifying how the notional amount should be calculated for certain routine commodity swaps. To that end, CMC members support Section II.C (Methodology for Calculating Notional Amounts) in the Edison Electric Institute's ("EEI's") letter on the *de minimis* threshold submitted in this docket. For ease of review, we have attached a copy of Section II.C as **Exhibit I** hereto.

The Commission should not adopt a rule allowing the Division of Swap Dealer and Intermediary Oversight ("DSIO") to make such determinations without allowing for a public comment period. Market participants should have a full opportunity to provide comments on matters of this importance.

VI. Conclusion

Thank you for the opportunity to provide comments to the Notice of Proposed Rulemaking, *De Minimis Exception to the Swap Dealer Definition*. If you have any questions or concerns, please do not hesitate to contact Kevin Batteh at Kevin.Batteh@Commoditymkts.org.

Sincerely,

Dr. James Newsome
President
Commodity Markets Council

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[11] *See* Parts 43 and 45 of the CFTC's regulations; *see also* Amendments to Swap Data Recordkeeping and Reporting Requirements for Cleared Swaps, 80 Fed. Reg. 52544 (Aug. 31, 2015); Margin Requirements for Uncleared Swaps for Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016).

Edison Electric INSTITUTE

Exhibit I

Responses to Commission Questions on Calculation of Notional Amount

(1) Should the notional amount (either stated or calculated) for transactions with embedded optionality be delta-adjusted by the delta of the underlying options, provided that the methods are economically reasonable and analytically supported? Should delta-adjusted notional amounts be used for all asset classes and product types, or only some?

Yes, the delta-adjusted notional amount should be used for all types of options in all asset classes, including options embedded in a swap, swaptions (i.e., an option that is exercisable into a swap) and regular options (i.e., a call option that is financially settled). If a swaption is exercised into a swap, the notional amount will be adjusted and calculated in accordance with the methodologies set out in question 5 below based on the type of swap being entered into. Delta adjusting the notional amount of options is a common risk management practice that market participants use to measure the notional amount of options. Joint Associations support the Letter from Futures Industry Association Principal Traders Group (Dec. 20, 2012) (proposing a methodology that does not utilize premium value or the strike price but does include option delta in the calculation).

Example: A producer interested in locking the price of future production may hedge price exposure by selling a swap at a fixed price of $3.00/MMBtu for a volume of 75,000 MMBtu.[1] Alternatively, the producer may sell an option to hedge a comparable level of exposure by selling a call with a strike of $3.50/MMBtu for a volume of 300,000 MMBtu. If you assume that the delta of the option is 0.25, the resulting delta-adjusted position (300,000 MMBtu * .25) equals the volume of the swap (75,000 MMBtu).

(2) For swaps without stated contractual notional amounts, should "price times volume" generally be used as the basis for calculating the notional amount?

Yes, the calculation generally should be price times volume. If a swap does not have a stated notional amount (*e.g.*, a floating monthly notional quantity), then absent CFTC-staff guidance, market participants should be able to rely on current commercially reasonable practice for calculating the notional amount of the swap.

(3) What other notional amount calculation methods, aside from "price times volume," could be used for swaps without a stated notional amount that renders a calculated notional amount equivalent more directly comparable to the stated contractual notional amount typically available in IRS, CDS, and FX swaps? (Footnote 155: "Price times volume" is similar to a cash flow calculation, while "stated contractual notional" is usually the basis that forms a cash flow calculation when combined with price, strike, fixed rate, coupon, or reference index. Therefore, "stated contractual notional amount" may be described as more similar to "volume" than

[1] The term "volume" in these comments means the notional quantity per calculation.

"price times volume." For example, for a $100 million interest rate swap, the stated notional amount is typically the basis of the periodic calculated cash flows instead of the actual cash flows, which are calculated using the stated notional amount and the stated "price" per leg (such as a fixed or floating rate index).

Joint Associations are not aware of a gross notional amount calculation for commodity swaps other than price times volume. However, as discussed in response to question 5 below, the price and volume will vary by product type (e.g., a basis swap will use the spread between legs 1 and 2 prices, multiplied by the volume of one leg and a fixed vs floating rate swap will use the fixed price as the price multiplied by the volume of the fixed leg).

(4) For swaps without a stated contractual notional amount, does calculation guidance exist in other jurisdictions and/or regulatory frameworks, such as in banking, insurance, or energy market regulations? Should persons be permitted to use such guidance to calculate notional amounts for purposes of a de minimis threshold calculation?

Joint Associations are not aware of other gross notional amount calculation methodologies in energy market regulations. The Federal Energy Regulatory Commission's electric quarterly reports (EQR) and Form 552 do not address a notional amount calculation for physical transactions and do not apply to financial transactions. If a swap does not have a stated notional amount (*e.g.*, a floating monthly notional quantity), then absent CFTC-staff guidance, market participants should be able to rely on current commercially reasonable practice for calculating the notional amount of the swap.

(5) What should be used for "price" when calculating notional amounts for swaps without a stated contractual notional? Contractual stated price, such as a fixed price, spread, or option strike? The spot price of the underlying index or reference? The implied forward price of the underlying? A different measure of price not listed here?

The answer depends on the type of swap (e.g., fixed vs float, basis swap, heat rate swap, option, etc.). In the CFTC's FAQ about Swap Entities from October 2012, the FAQ provides that if the asset underlying the swap is a physical commodity (e.g., natural gas), the notional amount calculation should take into account the "fair market value" of the commodity at the time the swap is executed. For the most commonly traded commodity swaps, members continue to follow the calculation methodologies set out in our September 20, 2012 joint comment letter and summarized briefly below:

- For a <u>fixed vs float swap</u> involving the same commodity, the "fair market value" would be the fixed price. For example, in a monthly on-peak power swap, the buyer of a notional quantity of electricity would pay a fixed price and the seller would pay the day-ahead locational marginal price or an index price.

- For a <u>float vs float</u> swap involving the same commodity, the "fair market value" would be the price differential between the two floating indices. In the market, each spread product type is quoted and transacted as a spread; therefore, the spread value (price) is appropriate when determining the notional amount.

- Index Spread: A gas index spread is where one party exchanges the variability of one index for another. For example, in the natural gas markets, one counterparty might pay a First of the Month Index price and receive a *Gas Daily* price in exchange. The "fair market value" or "price", is the spread or difference between the two indices. Often, the notional amount of an index spread swap is small given the similarity in the market price of both indices in the forward months.

- In electricity markets, an electric index trade is typically used to manage the price risk difference between the day-ahead and real-time markets. For example, a counterparty might pay the RTO Day Ahead LMP price and receive the RTO Real Time LMP price in exchange. The "fair market value" or "price", is the spread or difference between the two indices.

- Basis Spread: For a gas basis spread swap, payments are based on the value of the price spread between two locations (for natural gas it is typically the price spread between Henry Hub and another location). A basis trade is typically used in the electricity market to manage the price risk between two locations. For example, a counterparty might pay the fixed price for the difference between AEP Dayton Hub (ADHUB) and Northern Illinois Hub (NIHUB) and receive the floating price difference between those two locations. The "fair market value" or "price", is the spread or difference between the two price locations.

  The CFTC's FAQ about Swap Entities from October 2012 supports use of the spread as the "price" for locational basis swaps.

- Time Spread: In this type of swap, the payments are based on the spread value between two different delivery periods or points in time (such as natural gas or agricultural winter/summer seasonal spreads). For instance, a market participant could buy a summer month while simultaneously selling a winter month, hedging or locking in the value of the summer-winter spread. The "fair market value" or "price", the difference between the price for the two different delivery months.

- Spark Spread: An electric heat rate trade is typically used to manage price risk by using the prices of two commodities: electricity and natural gas. For example, a counterparty would pay the heat rate multiplied by NYMEX Gas (i.e., 9.50 * $3.00) and receive a fixed price for power ($30). The "fair market value" or the "price" to be used is the spark spread of $1.50 ($30-($3 * $9.50)).

- For the most commonly traded commodity options, Joint Associations members generally follow either the calculation methodologies set out in EEI's September 20, 2012 joint comment letter[2] or the Letter from Futures Industry Association Principal

[2] "Notional Amount" Calculation Methodology under Swap Dealer *De Minimis* Determination (RIN 3235-AK65) and Other CFTC Swap Regulations, American Petroleum Institute ("API"), Commodity Markets Council ("CMC"), Edison Electric Institute ("EEI"), Electric Power Supply Association ("EPSA"), Independent Petroleum Association of America ("IPAA") and Natural Gas Supply Association ("NGSA") (September 20, 2012) (reflects the predominant view among coalition members regarding the most logical and appropriate methodology for calculating "notional amount" with respect to certain types of commodity swaps in which coalition members regularly trade).

Traders Group (Dec. 20, 2012) (proposing a methodology that does not utilize premium value or the strike price but does include option delta in the calculation).[3]

(5.a) Should the price of the last available transaction in the commodity at the time the swap is entered into be used for this calculation?

No. The price should not be the last available transaction in the commodity because market participants may not capture the last available transaction data in their trading systems. The price should be the price referenced in the swap at the time of executing the transaction accounting for the forward curve as applicable.

(5.b) Is it appropriate to use a "waterfall" of prices to calculate notional amount, depending on the availability of a price type? (Footnote 156 For example, contractual stated fixed price might be required to be used first. Lacking a stated fixed price in the swap, spot price of the underlying would then be used instead.).

A waterfall concept is not necessary if the Commission follows the industry standard pricing approach as set forth above in this question 5. The price should be the price referenced in the swap at the time of executing the transaction accounting for the forward curve as applicable

(6) What metric should be used for "price" for certain basis swaps with no fixed price or fixed spread?

As described in response to question 5, the "price" should be the spread or price differential between the two floating prices.

(7) How should the "price" of swaps be calculated for swaps with varying prices per leg, such as a predetermined rising or falling price schedule?

For fixed-for-floating swaps with a varying fixed price, Joint Associations recommend using a weighted average price.

(8) What metric should be used for "volume" when calculating notional amounts for swaps without a stated contractual notional amount? Should the Commission assume that swaps with volume optionality will be exercised for the full quantity or should volume options be delta-adjusted, too? For swaps with a predetermined fixed or varying volume, Joint Associations recommend using a weighted average volume for a settlement period. For swaps with embedded volume optionality, the volume options should be delta-adjusted in the same way as other options are. The fact that the option is embedded into the swap does not change the risk management profile of the option.

(9) Should the total quantity for a "leg" be used, or an approximation for a pre-determined time period, such as a monthly or annualized quantity approximation? (Footnote 157: For an example of "monthly notional amount approximation" rather than aggregated total notional quantity, see Proposed Instrument, supra note 154, at 24-26.

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[3] Request for Confirmation on Notional Amount Calculation Methodology for Swaptions, Future Industry Association Principal Traders Group (December 20, 2012).

Consistent with the current Commission staff guidance, the duration of a swap should not be a factor in calculating the gross notional amount of a swap.[4] The volume used to calculate the gross notional amount should be the notional quantity used to calculate the payments between the parties per settlement period. Typically, commodity swaps settle monthly, therefore the volume used to measure the gross notional amount of swaps that settle monthly should be the notional quantity used to calculate the monthly settlement. As noted in response to question 2, if a swap does not have a stated notional amount (e.g., a floating monthly notional quantity), then absent CFTC-staff guidance, market participants should be able to rely on current commercially reasonable practice for calculating the notional amount of the swap.

(10) How should the "volume" of swaps be calculated for swaps with varying notional amount or volume per leg, such as amortizing or accreting swaps?

For swaps with a varying quantity per calculation period, the volume should be a weighted average of the notional quantity per settlement period.

(11) Should the U.S. dollar equivalent notional amount be calculated across all "legs" of a swap by calculating the U.S. dollar equivalent notional amount for each leg and then calculating the minimum, median, mean, or maximum notional amount of all legs of the swap?

Yes, and the calculation should allow for a netted notional amount across all legs of a swap or option that is traded and priced as one transaction. The CFTC's October 2012 FAQ about Swap Entities provides that a collar should be treated as having a single notional amount.

(12) Should the absolute value of a price times volume calculation be used, or should the calculation allow for negative notional amounts?

The calculation should net notional amounts in the context of a multi-leg structured swap or option where multiple legs are traded and priced as one transaction but documented as separate transactions. For example, in a three-way option collar, similar to the option collar the calculation should be based upon a netted delta-adjusted notional amount across all legs. If the netted notional amount is a negative value, the absolute value of the net amount should be used in the calculation.

(13) Given that a derivatives clearing organization ("DCO") has to mark a swap to market on a daily basis, it may be possible to determine "implied volatilities" for swaptions and options that are regularly marked-to-market, such as cleared swaps, in order to delta-adjust them. Should DCO evaluations be used when there are not better market prices available?

This is not applicable to commodity swaps and options as such products are not cleared by a DCO.

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[4] *See* Frequently Asked Questions (FAQ) – Division of Swap Dealer and Intermediary Oversight ("DSIO") Responds to FAQs About Swap Entities, page 2-3 (Oct. 12, 2012) (available here).